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SUBJECT: Austrians Reject Krugman Warning on Default  
Risk from Eastern Europe Exposure

REF: a) Vienna 365; b) Vienna 329 and previous

Sensitive but Unclassified - Not for Internet Use.

¶1. (SBU) SUMMARY. Senior Austrian politicians and economists rejected economist Paul Krugman's comment this week that Austria is a prime candidate for Iceland-style default due to its banking exposure in Central, Eastern, and Southeastern Europe (CESEE). Krugman's remarks drew intense coverage in Austrian media, prompting leading Austrians to blast his analysis as a ill-informed alarmism. The episode gives insight into Austrian's evolving economic crisis.

NOTE: see additional graphics at  
[www.intelink.gov/wiki/Austria%27s\\_Financial\\_C\\_risis](http://www.intelink.gov/wiki/Austria%27s_Financial_C_risis)  
END SUMMARY.

Krugman Sees Dark Clouds on Austria's Horizon  
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¶2. (U) In response to an Austrian journalist's query at an April 13 USG-sponsored Foreign Press Center event, Paul Krugman (2008 Economics Nobel prizewinner and New York Times columnist) was highly negative on financial stability in Austria. Krugman pointed out that Iceland showed that even "advanced countries" can "essentially go bankrupt" and surmised that Austria's large exposure in Eastern Europe (a regional crisis "at least as bad as the East Asian crisis of the 1990s") puts Austria just behind Ireland in terms of default risk. Krugman later argued that worldwide crises tend to have false dawns followed by renewed downturns -- citing "Austria going into default" as a potential trigger for a deeper collapse in Europe.

¶3. (U) Excerpt of Krugman briefing (full transcript at <http://fpc.state.gov/121662.htm>):

... the scale of the output collapses in Eastern Europe are looking fully comparable to East Asia, in fact, in some ways looking fully comparable to the Great Depression. And it is ugly. It's - Austria with a large exposure there, I mean, I haven't done the sums, but it does look pretty scary ... we've seen one advanced country essentially go bankrupt. Now it's a tiny one, it's Iceland, but that just shows that it can happen, even to advanced countries. Ireland looks pretty bad because of large financial exposure. And Austria would probably be my third candidate in those leads. I don't have a - it's just - it's a huge exposure

to a very, very troubled region. Maybe expanded IMF facilities will provide enough cushion that the thing won't actually really go that bad.

#### Angry Austrian Reactions

14. (SBU) Senior Austrian politicians and economists were united in rebutting Krugman, with several expressing anger that world markets are nonetheless likely to "punish" Austria after such remarks. Vice-Chancellor / Finance Minister Josef Proell expressed anger at Krugman's warning and dismissed the suggestion that Austrian banks could experience a system-wide collapse and default. Proell pointed out that Austrian banks' EUR 200 billion loan portfolio in CESEE is 85% covered by deposits (NOTE: the figure excludes Italian-owned Bank Austria and German-owned Hypo Alpe Adria). The last thing Austria needs, Proell opined, is more unsubstantiated fear-mongering which leads to market pressure against Austrian assets. Proell said Austria's triple-A-rating is not in any danger. Proell said CESEE loan losses of up to 10% are realistic (an EBRD estimate), but even then losses should not strike in all 20 countries at the same time. Proell hinted darkly that Krugman-style remarks represent deep-seated "envy" of Austria's success in Eastern Europe and/or "economic warfare" against Austria (COMMENT: a very odd notion, but one that has gained currency in some Austrian quarters. END COMMENT).

VIENNA 00000451 002 OF 002

15. (U) Like FinMin Proell, National Bank Governor Ewald Nowotny said that there's no chance of a default or economic collapse in Austria and that current measures are sufficient to address the crisis. Nowotny pointed out that Fitch and Moody's recently confirmed their 'Triple A' rating for Austria and cited Austria's total public sector debt of 62.5% (end-2008) as lower than the Euro-zone average. Leading private-sector economist Bernhard Felderer dismissed Krugman's analysis as ill-informed (citing his remark "I haven't done the sums") and said Krugman makes "the usual mistake" of painting all of Eastern Europe with the same brush. Felderer called the prospect of bankruptcy in Austria "virtually nil."

16. (U) Only Austria's far-right opposition embraced the Krugman warning as further evidence of the bankruptcy of Austria Incorporated and the GoA mis-handling of the economy. Freedom Party/FPOe General Secretary Harald Vilimsky said that Krugman's remarks "confirm" the party's repeated warnings about Austria's financial crisis.

COMMENT

17. (SBU) The episode highlights some key contours of Austria's evolving economic crisis:  
-- "Circling the Wagons" -- Austrian commentators on left and right were virtually unanimous in rejecting Krugman's analysis. Both industry and labor joined in the critique.  
-- "Hinting at Ignorant or Malevolent Anglo-Americans" As after the Moody's downgrade warning on February 18, senior Austrian politicians bash negative forecasts as the work of discredited or uninformed London/New York-based analysts. (Of course, as a 2008 Nobel laureate who predicted the crisis, Krugman is anything but discredited ...)  
-- "We're the Baby, not the Bathwater" Austrians say negative analyses treat CESEE as a single crisis zone

and don't consider Austria's strengths. Unlike Iceland and Ireland, Austrian banks did not attract large short-term inflows, nor did they invest heavily in structured assets.

-- "The Check's in the Mail" Parts of Austria's large (EUR 100 billion) bank rescue package are only now going into effect. There are early signs it is working (ref A).

There is merit to the last two points; the first two are primarily signs of Austrian political culture under stress. Krugman stands by his analysis: see his blog entry at <http://krugman.blogs.nytimes.com/2009/04/15/austria/>

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